ICAEW FINANCIAL SERVICES FACULTY

Helpsheet

SUBSIDIARY BOARD GOVERNANCE IN GROUPS PLANNING

April 2016

WHY IS IT AN ISSUE

International financial services groups would prefer not have subsidiary governance at all. Unconstrained, they would choose to exercise control through the management structure - in the same way that non-financial services corporates do. However, local financial services regulators do not like that model. Instead, they want the statutory board of the regulated entity (the subsidiary) to have real authority over the business that relates to its local balance sheet, markets and customers.

For groups that use matrix management structures, where no single executive owns the local balance sheet, this can be particularly problematic.

There is also potential for conflict between the local regulator, which would like a subsidiary board to have complete authority – and the legitimate desire of the group holding company, to control its investment.

The key to managing this conflict is to:

1. make local governance a useful component of group governance,
2. define a role of the local subsidiary board which meets the interest of the regulators and of the group and
3. ensure the local board is properly equipped to fulfil that role.

USEFUL ROLE FOR SUBSIDARY GOVERNANCE

Larger groups with perhaps more complex group structures, recognise that subsidiary boards can be advantageous and aid risk management. They can help:

- manage the problems of growth,
- exert consistent standards,
- understand behavioural norms and
- respond to regulators.

To help make subsidiary boards' effective, the parent company's risk response needs to involve embedding sound governance across complex group structures to complement management control, and to give those at the centre greater confidence that the group is under control. This then leads to a two-way flow that both parties benefit from maintaining.

Diagram 1: Two-way flow

The key to a useful subsidiary board, which also satisfies the regulator, is to start by explicitly recognising that the local board is there because the local regulator requires it. But what exactly does the local regulator want? Essentially, it is that the board should make a positive contribution to management of the subsidiary's prudential and conduct risk. Done constructively this will also benefit the group. However, there are some areas where subsidiary boards do not have the authority of stand-alone boards. For example, subsidiary boards:

- do not have the right to abandon the group strategy and go off in a completely different direction.
- they do, however, have not just the right but the responsibility to push back against the group strategy if they think it is too risky (e.g. in putting too much pressure to grow the local balance sheet).
- they should voice concerns if things could be improved (e.g. by investing more to take advantage of local opportunities).
- they cannot ignore the group risk appetite, but they can request a lower appetite locally if they believe that the group appetite is too aggressive for the local business to sustain.

So a starting point is to have a clearly-defined role for the local board that is centred on risk management, 2015 positions the subsidiary board as a valuable part of the overall group governance, and sets out where the board's authority and responsibility intersects with

that of the parent. Then the next thing is to enable the subsidiary board to be effective in that role.

ONE SIZE DOES NOT FIT ALL

Even well integrated groups need the flexibility to allow for local variations in factors such as:

Management capability	Local politics	Regulatory regimes
Cultural norms	Quality of advisors/auditors	Escalation practices
The fit in the matrix	Control attitudes	Laws

A policy statement and compliance checklist from head office will not be enough to drive good governance.

WHAT HELPS MAKE SUBSIDIARY GOVERNANCE EFFECTIVE?

1. A precise statement (terms of reference) on the role of the subsidiary board, with guidance on the level of autonomy and the flexibility granted to the subsidiary body.

2. Clarity over the participation of group executives on the subsidiary board (quasi-independent non-execs).

3. Document the subsidiary's ability to influence local strategy.

4. Formally agree how the local board ensures that stress testing takes account of actual and potential circumstances in the local market.

5. The local board should develop and maintain a clear view of the subsidiary-level risk profile and how it is affected by (and affects) risk exposures and management from other parts of the group.

6. Clarify the local board's ability to influence internal audit and risk management, if these are group functions.

7. Define when and how the local board should escalate significant issues and the group's obligation to respond.

8. Assess local dependence on group services and how effectively this 'outsourcing arrangement' is managed.

9. Consider the level of group support for information systems, transactional data, management information systems and how the local board gets comfort over local IT-related risk exposures and security standards.

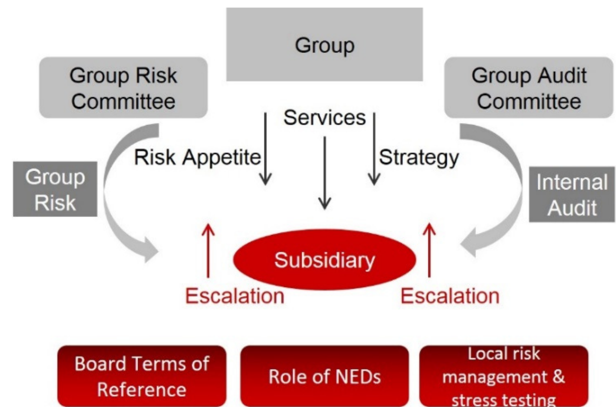
10. Review the quality and usefulness to the local board of statutory and management reporting.

11. Integrate subsidiary Enterprise Resource Planning systems into global structures and assess how this impacts local information flow and management reporting.

12. Agree the subsidiary's ability to influence local management appointments and remuneration.

13. Review how the local board assesses its culture, ethics and escalates the effect of these to group.

Diagram 2: How effective governance might work



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ISBN 978-1-78363-654-9

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TECPLN14884 04/16